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Summary of the economic survey of Europe, 1997

Executive summary

The economic situation improved significantly in much of the region of the Economic Commission for Europe (ECE) in 1997. In the Western market economies (Western Europe and North America), it was the best year for gross domestic product (GDP) growth – an average 3.3 per cent – since 1989. In the transition economies of Eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS), it was the first time since 1989 that the average growth rate was positive (1.7 per cent), this being a reflection of continued steady growth in Eastern Europe and, finally, the apparent end to seven consecutive years of falling GDP in the Russian Federation.

The outlook for economic developments throughout the region in 1998 depends to a considerable extent on how serious the ramifications of the 1997 crisis in Asia are likely to be. Most forecasts for the world economy have been lowered since last December and these imply a reduction of between ½ and ¾ of a percentage point in the forecasts made last autumn for Western Europe and North America: the *Economic Survey of Europe, 1998*, No. 1, however, stresses two points: first, that the Asian crisis is complex in that it is likely to affect a large number of variables not all of which are easy to estimate or include in the standard forecasting models; and, second, that actual developments will also depend on the monetary and fiscal policies adopted in the major market economies.

The current national forecasts point to no change in the average annual rate of GDP growth in Western Europe, that is to say, it is expected to remain at about 2.7 per cent. In the slow-growing countries of the last few years (France, Germany and Italy), GDP should pick up gradually (to some 2.5 to 2.8 per cent) but this will be offset by slower growth in the United Kingdom of Great Britain and Northern Ireland and in many of the smaller European economies.

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In the United States of America, domestic demand is still likely to remain quite strong in 1998, but the effective exchange-rate appreciation of the dollar and the spillover effects from Asia are likely to produce a significant fall in net exports. In short, GDP growth is expected to slow to about 2.5 per cent, from 3.8 per cent in 1997. This would imply an average growth rate of just over 2.5 per cent for the ECE market economies as a whole.

The direct effects of the Asian crisis on the transition economies are likely to be small. The main effect of any global shocks on Eastern Europe will be felt through their impact on Western European import demand. There could also be important effects on the supply of net capital inflows and the cost of financing.

In aggregate, Eastern European GDP is expected to grow by about 4½ per cent in 1998. This improvement on the 1997 performance would be largely due to a return to growth in Albania and Bulgaria and an end to decline in Romania. High rates of growth (5 to 7 per cent) are also expected in the Baltic States. An important problem facing many Eastern European economies in 1998 is how to handle their large current account deficits (many of these are 6 per cent or more of GDP and the figures are even higher in the Baltic States).

Among the major uncertainties identified as facing the ECE economies in 1998 are whether the Asian crisis will have much larger negative effects on real activity than are currently allowed for; and whether the introduction of the Eurodollar (Euro) will entail tighter fiscal policies in Western Europe. On both counts, the *Survey* takes the view that the downside risks are not negligible. Finally, there is a discussion of the risk of possible lowering of growth rates in the transition economies through exposure to increasingly volatile international capital flows.

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[1] The region of the Economic Commission for Europe (ECE) comprises the member countries of ECE, namely, the whole of Europe (East and West, including the Baltic States), the Commonwealth of Independent States (CIS), North America and Israel.

[2] United Nations publication, Sales No. E.98.II.E.1.

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Overview of the economic situation and selected issues in the region of the Economic Commission for Europe (ECE)

A. Economic developments in 1997

1. The economic situation improved significantly in much of the region of the Economic Commission for Europe (ECE)[1] in 1997. In the Western market economies (Western Europe and North America), it was the best year for gross domestic product (GDP) growth — an average 3.3 per cent — since 1989 (see table 1). In the transition economies of Eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS), it was the first time since 1989 that the average growth rate was positive (1.7 per cent), this being a reflection of continued steady growth in Eastern Europe and, finally, the apparent end to seven consecutive years of falling GDP in the Russian Federation.

2. The relatively high growth rate of the Western economies was heavily influenced by the unexpected strength of the economy of the United States of America where buoyant domestic demand was responsible for an increase in GDP of 3.8 per cent, the largest rise since 1988. Household expenditures increased strongly (3.3 per cent), but so did fixed investment, which rose nearly 6.5 per cent (table 2). Business spending on computers and information technology was particularly strong (up 20 per cent) and since 1991 had increased in volume by 161 per cent. Despite the perennial fears that the introduction of new technology destroys jobs, total employment since 1991 had risen 13 per cent and in 1997 the average unemployment rate was 4.9 per cent, the lowest it had been since 1973. Although technical change, just like increased imports from developing countries, may create local problems of adjustment for individual groups of workers — and if they are unable to acquire new skills their relative income position may deteriorate — it is unlikely to be a major cause of unemployment in a growing economy. An important lesson to draw from the United States experience is that faster economic growth and a high rate of investment are very effective in reducing unemployment and coping with technological and structural change. Moreover, this combination — which, instead of being a new economic paradigm, reflects the rediscovery of the Keynesian insight of the 1950s and 1960s that full employment is possible with low inflation — sets up a virtuous circle of increased employment, higher productivity and low inflationary pressures. Fixed investment in the United States in 1997 raised the productive capacity of the manufacturing industry by more than 5 per cent and, despite the rapid growth of the last six years, capacity utilization rates are still several points below their peak in 1989. Productivity in manufacturing rose by nearly 4.1/2 per cent in 1997 and easily absorbed the rise in wages, with unit labour costs actually falling. The greater part of new jobs in the United States have been created in the services sector, in particular in business services which have also had high rates of investment in new technology.

3. In Western Europe, the growth of GDP averaged 2.7 per cent in 1997, a clear improvement on the 2 per cent increase in 1996. There was a steady, but by no means dramatic, improvement in domestic demand during the year and this tends to have a multiplier effect through the European economies because of their very close trading links. Nevertheless, Western European growth was still largely driven by exports and especially by the import demands of North America, the transition economies of Eastern Europe and CIS, and developing countries outside East Asia. Fixed investment picked up a little in 1997 (it rose by nearly 2.1/2 per cent against 1.6 per cent in 1996) but it was very weak in France, Germany and Italy; and even in the United Kingdom of Great Britain and Northern Ireland, where growth has been relatively strong for the last four years and profits relatively high, the increases were not very large. The investment that has taken place has tended to be in machinery and equipment rather than new buildings, and focused on the rationalization of production rather than the expansion of new capacities that would lead to higher employment.

4. Just as the contrast is frequently drawn between the dynamism of the United States economy and the slow growth of that of Western Europe, so within Europe a comparison is often made between the United Kingdom's buoyant economy and the continent's sluggish one. However, this is misleading since many of the smaller economies have in fact been growing rapidly since 1993, often at rates above that in the United Kingdom. Fixed investment in most of these smaller European economies has risen strongly, including business investment in new buildings; unemployment rates have been falling; and new jobs have been created at rates comparable with, or above, those in the United States and the United Kingdom. Within this sample of smaller economies, the variations in the institutional context of economic activity, particularly as regards the degree of labour-market regulation, are considerable and, given their economic performance, must raise serious doubts about the simplistic characterization of continental European labour markets as rigid and inflexible

Table 1
Growth of real GDP in the ECE market economies, 1995-1998
(Percentage change over previous year)

	1995	1996	1997[a]	1998[b]
Western Europe	2.7	2.0	2.7	2.7
European Union	2.5	1.7	2.6	2.7
Four major countries	2.3	1.4	2.4	2.5
France	2.1	1.5	2.4	2.8
Germany	1.8	1.4	2.2	2.5
Italy	2.9	0.7	1.5	2.5
United Kingdom	2.7	2.3	3.5	2.0
Seventeen smaller countries	3.3	3.0	3.5	3.2
Austria	2.1	1.6	2.0	2.5
Belgium	2.1	1.5	2.1	2.5
Cyprus	5.5	1.9	2.4	4.0
Denmark	2.6	2.7	3.0	2.7
Finland	5.1	3.6	5.9	3.5
Greece	1.8	2.6	3.4	3.0
Iceland	1.2	5.2	4.9	3.9
Ireland	10.4	7.7	8.5	6.5
Israel	6.4	4.5	2.1	2.5
Luxembourg	3.7	3.0	3.6	3.7
Malta	7.3	4.2	2.8	..
Netherlands	2.3	3.3	3.2	3.2
Norway	4.1	5.3	3.5	4.0
Portugal	1.9	3.0	3.4	3.5
Spain	2.7	2.3	3.4	3.5
Sweden	3.9	1.3	1.9	2.5
Switzerland	0.8	-0.2	0.7	1.5
Turkey	7.2	7.0	6.3	4.0
North America	2.0	2.6	3.8	2.6
Canada	2.2	1.2	3.8	3.2
United States	2.0	2.8	3.8	2.5
Total	2.3	2.3	3.3	2.6
Memorandum item:				
Japan	1.5	3.9	0.9	0.1
Total, including Japan	2.2	2.6	2.9	2.2

Sources: National statistics and national economic reports; OECD *Economic Outlook* (Paris), December 1997.

Note: All aggregates excluding Israel. Two dots (..) indicate data are not available.

[a] Preliminary estimates.

[b] Forecasts.

in contrast with the superior job-creating flexibility of labour markets in the United Kingdom and North America.[2] The European countries where unemployment has fallen most since 1993 tend to be those where, as is the case for the United States, economic growth and fixed investment have been strongest.

5. A general feature of developments in the Western market economies in 1997 was the persistence of very low rates of inflation and the absence of any serious incipient labour or other cost pressures. In Western Europe, the increase in consumer prices averaged less than 2 per cent in 1997, and despite a long period of sustained output growth it was also under 2 per cent in the United States towards the end of the year. There are many factors that have been suggested to explain this outcome, including labour-market deregulation, the declining influence of trade unions, increased competition in more open and interdependent economies, and widespread fears of unemployment, especially in Europe, where in the 1990s priority has been given to fiscal consolidation over growth and employment. Nevertheless, the experience of the United States and many of the smaller economies of Western Europe also suggest that growth, investment and rising productivity are playing an important role in sustaining low inflation and increased employment. More generally, the aftershocks of the inflationary crisis of the 1970s now seem to have worked themselves out of the system, and this has been accompanied by a decline of inflationary expectations to levels prevailing before the 1970s. Inflationary pressures will obviously tend to continue to emerge but these are more likely to reflect normal fluctuations in the business cycle and as such are easily reversible. A more worrying concern has been raised in a general way by the Chairman of the Board of the Federal Reserve System of the United States, namely that at very low rates of inflation there is an increased risk, because of upward biases in the available measures of consumer price inflation, of an economy's possibly being tipped into deflation owing to a too hasty tightening of monetary policy.[3]

6. In Eastern Europe and the Baltic States, 1997 was generally a year of relatively high rates of growth. The average rate of growth for Central and Eastern Europe (2.8 per cent) was actually much lower than in 1996 (4.1 per cent), but this was largely due to the large falls in GDP in Albania, Bulgaria and Romania, and a sharp deceleration of growth in the Czech Republic (see table 3). In these countries, policy makers have been grappling with the consequences of severe financial crises in 1996 and 1997, which in turn were the result of the existence of poor macroeconomic fundamentals, and weak reform

Table 2

Major components of demand in the ECE market economies, 1996-1997

(Percentage change over preceding year)

	Private consumption		*Government consumption*		*Gross fixed investment*		*Stock-building*		*Total domestic demand*		*Exports*		*Imports*		*Net exports*[a]	
	1996	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*
Western Europe	2.4	2.1	1.9	0.9	1.6	2.4	-0.4	0.4	1.7	2.3	5.5	9.0	4.3	8.1	0.3	0.4
European Union	2.0	2.0	1.5	0.7	1.1	2.1	-0.3	0.4	1.4	2.2	4.8	8.7	3.7	7.8	0.3	0.4
Four major countries	2.0	1.7	1.8	0.6	—	0.8	-0.3	0.6	1.2	1.9	4.1	8.6	3.0	7.7	0.3	0.4
France	2.1	0.9	1.7	1.6	-0.5	0.2	-0.5	0.1	1.0	1.0	4.8	11.3	2.8	6.6	0.6	1.4
Germany	1.4	0.2	2.6	-0.4	-1.2	0.2	-0.3	1.1	0.8	1.2	5.1	10.7	2.8	7.0	0.6	1.0
Italy	1.1	2.3	0.5	-0.7	0.4	0.6	-0.3	1.0	0.5	2.5	-0.6	6.5	-1.7	11.9	0.2	-0.9
United Kingdom	3.6	4.2	2.0	2.3	1.8	2.7	-0.2	-0.1	2.7	3.5	6.8	4.9	8.4	5.6	-0.5	-0.3
Seventeen smaller countries	3.2	3.0	2.0	1.4	4.9	5.6	-0.6	-0.1	2.7	3.1	8.3	9.8	7.0	8.8	0.3	0.3
Austria	2.4	0.5	0.1	0.8	2.4	2.8	-0.6	0.1	1.4	1.2	9.3	6.5	8.7	4.8	0.2	0.8
Belgium	1.3	1.0	1.8	0.7	0.6	3.8	-0.1	0.2	1.1	1.7	3.2	4.9	2.8	4.5	0.4	0.5
Cyprus	2.5	-1.1	11.9	7.1	2.2	-5.2	-0.5	-0.2	3.2	-0.7	3.5	0.2	5.6	-4.5	-1.4	2.6
Denmark	2.6	4.0	2.4	2.0	7.5	7.2	-0.7	0.6	2.6	4.7	2.3	4.5	2.1	8.6	0.2	-1.4
Finland	3.8	3.1	3.5	-0.3	8.4	11.3	-0.7	0.3	3.7	4.3	3.9	13.5	4.3	9.3	0.2	2.1
Greece	2.3	2.3	0.5	2.5	9.4	11.7	1.0	1.2	3.8	4.7	0.2	3.7	3.9	6.7	-1.8	-2.0
Iceland	6.4	5.2	1.4	2.2	23.5	19.8	-0.7	—	7.1	7.1	10.0	4.0	16.6	10.3	-1.6	-2.0
Ireland	6.3	6.5	2.9	2.5	15.9	13.5	0.8	-0.1	8.4	7.1	10.0	13.0	11.4	12.3	0.6	2.5
Israel	5.2	3.3	5.5	1.8	6.8	-6.7	0.4	0.5	6.0	1.2	5.0	7.5	8.4	3.4	-2.5	0.7
Luxembourg	1.9	2.8	3.3	3.9	-1.7	8.0	0.6	-0.2	1.8	4.0	2.3	4.6	1.0	5.2	1.5	0.1
Malta	6.0	2.8	8.0	0.1	-4.9	-5.5	0.8	-4.0	4.6	-3.7	-5.0	3.7	-4.9	-6.1	-0.2	6.4
Netherlands	3.0	3.1	1.2	2.1	6.1	6.1	—	-0.3	3.4	3.3	4.5	5.8	5.3	6.3	-0.1	0.2
Norway	4.7	3.0	3.3	2.5	4.8	15.1	-0.5	0.6	3.7	6.2	10.0	4.1	6.5	11.9	1.9	-2.2
Portugal	2.2	2.6	1.6	1.8	7.7	9.0	-0.1	—	3.4	4.1	7.7	8.3	7.5	8.7	-0.8	-1.2
Spain	1.9	3.1	0.1	0.7	0.9	4.7	-0.1	-0.4	1.4	2.7	9.9	12.9	6.2	10.1	0.9	0.7
Sweden	1.3	2.0	-0.2	-2.4	3.7	-0.6	-1.1	0.5	0.1	0.9	6.1	10.9	3.7	10.1	1.2	1.2
Switzerland	0.7	0.9	0.7	-0.3	-2.7	-1.5	-0.1	-0.1	-0.2	0.1	2.5	8.2	2.4	6.7	—	0.6
Turkey	9.3	6.0	8.6	4.7	13.5	6.6	-3.1	-0.7	7.2	5.4	21.7	17.5	19.0	13.4	-0.2	0.5
North America	2.6	3.3	-0.1	1.1	7.2	6.8	-0.1	0.6	2.8	4.2	8.1	12.1	8.8	14.2	-0.2	-0.5
Canada	2.4	3.9	-1.3	-0.1	4.8	11.4	-0.9	0.7	1.1	5.1	5.7	8.6	5.2	13.4	0.3	-1.4
United States	2.6	3.3	—	1.2	7.4	6.4	—	0.6	3.0	4.1	8.3	12.4	9.1	14.3	-0.2	-0.5
Total	2.5	2.7	0.9	1.0	4.4	4.6	-0.3	0.5	2.2	3.2	6.8	10.6	6.6	11.1	—	-0.1
Memorandum item:																
Japan	2.9	1.4	1.5	0.8	9.5	-4.2	0.1	-0.1	4.8	-0.5	3.5	10.9	11.5	-0.1	-0.8	1.4
Total, including Japan	2.5	2.5	1.0	1.0	5.2	3.2	-0.2	0.4	2.6	2.7	6.3	10.6	7.4	9.4	—	0.1

Sources: National statistics and OECD *Economic Outlook* (Paris), December 1997.

Note: All aggregates excluding Israel. A dash (—) indicates that the amount is nil or negligible.

[a] Percentage point contribution to annual GDP growth.

Table 3

Basic economic indicators for the ECE transition economies, 1995-1998

(Rates of change and shares: percentage)

	GDP (growth rate)					*Industrial output (growth rate)*			*Inflation (percentage change, December-December)*			*Unemployment rate (end of period, percentage)*		
			1997											
	1995	*1996*	*Ex ante forecast*	*Actual outcome*	*1998 forecast*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	5.9	4.1	3½	2.8	4½	8.0	5.8	5.7	..	..	..	12.5	11.8	11.6
Albania	8.0	9.1	..	-7*	12	-7.2	13.6	-5.6	6.0	17.4	42.0	13.1	12.1	13.4[a]
Bosnia and Herzegovina[b]	..	..	..	..	..	60.8	87.3	35.1	-34.2	3.2	12.2	..	..	..
Bulgaria	2.1	-10.9	-(2-4)	-7.4	3	9.1	-8.3	-7*	33.0	311.1	578.7	11.1	12.5	13.7
Croatia	7.1	6.0	5.5	6.5	5	0.3	3.1	6.8	3.7	3.5	4.0	17.6	15.9	17.6
Czech Republic	5.9	4.1	4-5	1.3	1.6-2.2	8.7	1.8	2.3	7.9	8.7	9.9	2.9	3.5	5.2
Hungary	1.5	1.3	2	4.0	4	4.5	3.4	11.1	28.5	20.0	18.4	10.4	10.5	10.4
Poland	7.0	6.1	5-6	6.9	5.6-5.8	9.7	8.3	11.3	22.0	18.7	13.2	14.9	13.2	10.5
Romania	7.1	4.1	-2	-6.6	—	9.4	9.9	-5.9	27.7	56.8	151.7	9.5	6.3	8.8
Slovakia	7.3	6.9	6	6.5	5	8.3	2.4	2.7	7.4	5.5	6.5	13.1	12.8	12.5
Slovenia	4.1	3.1	4	3.3	3.5-4	2.0	1.0	1.3	8.6	8.8	9.5	14.5	14.4	14.8
The former Yugoslav Republic of Macedonia	-1.2	0.7	..	..	5	-10.8	3.1	1[c]	11.2	0.3	4.5	37.2	39.8	42.4[c]
Yugoslavia[d]	6.1	5.9	13	7.4	10	3.8	7.5	9.5	110.7	59.9	10.3	24.7	26.1	25.6
Baltic States	2.1	3.7	4½	6.5	6	1.3	4.6	5.8	..	..	..	6.5	6.4	6.3
Estonia	4.3	4.0	4-5	9	5.5-6	1.9	2.9	13.4	28.8	14.9	12.3	5.0	5.6	4.6
Latvia	-0.8	2.8	3.5	6.0	5-6	-3.7	5.5	6.1	23.3	13.2	7.0	6.6	7.2	6.7
Lithuania	3.0	4.2	5	5.0	7	5.3	5.0	0.7	35.5	13.1	8.5	7.3	6.2	6.7
CIS	-5.5	-4.4	..	0.7	..	-5.9	-2.8	2.3	..	..	..	5.8	6.2	6.2
Armenia	6.9	5.8	..	3.0	5-6	1.5	1.2	1.0	32.0	5.6	21.8	8.1	9.7	11.0
Azerbaijan	-11.8	1.3	..	5.8	..	-17.2	-6.7	0.3	84.5	6.8	0.3	1.1	1.1	1.3
Belarus	-10.4	2.8	5	10.4	7-8	-11.7	3.5	17.6	244.2	39.1	63.4	2.7	4.0	2.8
Georgia	2.6	8.6	..	11.3	11-13	-9.8	7.7	8.1	57.4	13.6	7.3	3.4	3.2	2.6
Kazakhstan	-8.2	0.5	2	2.0	3.5	-8.2	0.3	4.0	60.4	28.6	11.3	2.1	4.1	3.9
Kyrgyzstan	-5.4	7.1	..	10.4	7	-17.8	8.8	46.8	31.9	35.0	14.7	3.0	4.5	3.1
Republic of Moldova[e]	-1.9	-7.8	5-7	1.3	..	-3.9	-6.5	-2.3	23.8	15.1	11.1	1.4	1.5	1.7
Russian Federation	-4.1	-4.9	0-2	0.4	1.2-2	-3.3	-4.0	1.9	131.4	21.8	11.0	8.9	9.3	9.0
Tajikistan	-12.4	-16.7	..	1.7	..	-13.6	-23.9	-2.5	2 382.2	40.6	159.9	1.8	2.4	2.8
Turkmenistan	-7.7	0.1	..	-20*	..	-6.4	17.9	-35*	..	..	..	..	..	..
Ukraine	-12.2	-10.0	—	-3.0	0.5	-12.0	-5.1	-1.8	181.7	39.7	10.1	0.6	1.5	2.8
Uzbekistan	-0.9	1.7	..	5.2	6	0.1	6.0	6.5	..	..	..	0.3	0.3	0.3
Total	**-1.3**	**-1.0**	..	**1.7**	..	**-1.6**	**0.2**	**3.6**	..	..	..	**7.5**	**7.8**	**7.7**
Memorandum items														
CETE-5	5.9	5.1	4½	5.4	5	8.5	6.1	8.9	..	..	..	12.0	11.3	9.9
SETE-7	5.9	2.1	..	-3.0	3	6.7	5.1	-2.5	..	..	..	13.7	12.5	14.2
Länder ex-GDR[f]	5.2	1.9	1.0	1.6	2	5.8	4.6	6.7	2.6	1.6	2.3	14.9	15.9	19.4

Sources: National statistics, Commonwealth of Independent States (CIS) Statistical Committee and direct communications from national statistical offices to the Economic Commission for Europe (ECE) secretariat (International Monetary Fund and World Bank data for Albania).

Note: Aggregates are ECE secretariat computations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or governmental forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation where it is the Goskomstat estimate according to the International Labour Organization definition and Estonia where it refers to job-seekers). Aggregates shown are Eastern Europe (the 12 countries below that line), with sub-aggregates CETE-5 (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SETE-7 (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, the former Yugoslav Republic of Macedonia and Yugoslavia), Baltic States (Estonia, Latvia, Lithuania), CIS (12 member countries of CIS, and total transition countries.

Two dots (..) indicate data are not available; a dash (—) indicates that the amount is nil or negligible; an asterisk (*) after a numeral indicates an ECE secretariat estimate.

[a] June.

[b] Data reported by the Statistical Office of the federation; these exclude the area of Republika Srpska.

[c] November.

[d] Gross material product instead of GDP.

[e] Excluding Transnistria.

[f] States of the former German Democratic Republic.

programmes, especially as regards the banking and enterprise sectors. At the root of most of these setbacks is the lack of a political and social consensus on a radical transformation programme. Considerable progress has been made towards establishing macroeconomic stability in Bulgaria, especially since the creation of a currency board in July 1997, but a long process of structural adjustment still lies ahead. The increasing divergence in terms of economic reform and development between these south-east European countries together with Bosnia and Herzegovina and Yugoslavia and those in Central Europe and the Baltic States is a matter of growing concern – not only because of the heavy costs to the people of south-east Europe but also because of the risks to economic and political stability in the region as a whole.

7. Apart from the setback to the Czech economy in 1997,[4] growth rates were generally higher than expected at the start of the year and in several countries (Croatia, Poland and Slovakia) GDP increased by 6 per cent or more. A strong recovery now appears to be well established in the Baltic States where growth in 1997 ranged between 5 per cent in Lithuania and 9 per cent in Estonia.

8. A major feature of the recovery in Central Europe is the rapid growth of the industrial sector. Industrial output in Hungary and Poland grew more than 11 per cent in 1997 and by some 7 per cent in Croatia; in Latvia it was more than 6 per cent and in Estonia over 13 per cent. Industry also seems to be attracting a large share of the expansion in fixed investment: investment in industry has grown strongly in recent years in Croatia, the Czech Republic, Poland, Romania, Slovakia and Slovenia; in Poland, for example, about half of all private sector investment last year was in the manufacturing industry. Some of the effects of this new investment are beginning to appear in the changing structure and improved competitiveness of exports of manufactured goods.[5] Contrary to earlier expectations that the services sector would be the principal source of new jobs as the general restructuring process got under way, industry appears to be the main generator of private sector employment. New jobs in services are not negligible but only in the Czech Republic are services the major source of the jobs.[6] Thus, far from developing a post-industrial economy dominated by services, most of the Eastern European transition economies seem to be embarking on a process of reindustrialization with a strong export orientation.

9. Despite high rates of economic growth, there was only a marginal rise in the total level of employment in Eastern Europe in 1997, and this was largely due to Poland where output has been growing strongly for five years. Unemployment rates remain high – an average of 11.6 per cent in Eastern Europe at the end of 1997, 6.3 per cent in the Baltic States – and, again, only in Poland has there been a significant improvement (as reflected by a decline in the unemployment rate from 13.2 to 10.5 per cent between December 1996 and December 1997). Given the depth of the transition recession in Eastern Europe and the scale of the restructuring under way, it is not very surprising that employment is slow to respond to the recovery in output. In Poland, employment continued to fall for at least two years after the recovery in output had started. This underlines the importance of sustaining the highest feasible growth rates over a number of years.

10. In spite of serious setbacks in some of the south-east European economies, inflation rates have fallen markedly in most of the transition economies in the last few years, although progress was less marked in Eastern Europe in 1997. Leaving aside Albania, Bulgaria and Romania, the average increase in consumer prices in Eastern Europe and the Baltic States in 1997 ranged from 4 per cent in Croatia to over 18 per cent in Hungary. The rate of increase in wages has continued to fall and widespread improvements in productivity, largely associated with increased output, have considerably lowered the growth in unit labour costs. An important feature of measured inflation rates in Eastern Europe and the Baltic States is that they still contain a significant component of relative price adjustments. Despite the rapid liberalization of prices of goods, the prices of many services (rents, utilities, public transport and so on) as well as energy prices are being only gradually increased to market levels so as to avert social hardship and unrest. This gradual decontrol of administered prices helps to explain the persistent high growth of service prices in most of the transition economies which in turn contributes to the persistence of moderately high rates of overall "inflation". Clearly, it is important to bear in mind this relative price effect when assessing progress towards macroeconomic stability in the above-mentioned economies. The relatively lower inflation rate in one or two countries rather than signal the success of a stabilization policy, reflects a reluctance to make the necessary adjustments to administered prices with its promise of greater problems in the future.

11. As regards CIS, the most significant macroeconomic development in 1997 was the apparent end of seven years of falling output in the Russian Federation. The increase in GDP was marginal and the prospects for continued recovery are uncertain, but there are nevertheless signs of improvement in various parts of the economy. The main source of growth was in the manufacturing industry with a recovery taking place in a number of sectors. There was also

a revival of consumer demand for the first time since 1990 and Russian manufacturers appear to be starting to regain shares in their domestic market. One of the major achievements in the Russian economy has been the reduction in the inflation rate from an annualized quarterly rate of 400 per cent in early 1995 to 2.8 per cent in the last quarter of 1997.

12. Output was also growing in all the other CIS countries in 1997 except Turkmenistan and Ukraine, and there was also a significant fall in inflation rates in most of them. Tight monetary policies and stable exchange rates were largely responsible for the latter, although higher productivity, and increased price stability in the Russian Federation, the principal trading partner of the other CIS countries, also had an influence.

B. Outlook for 1998

13. The outlook for economic development throughout the region in 1998 depends to a considerable extent on how serious the ramifications of the 1997 crisis in Asia are likely to be.[7] Most forecasts for the world economy have been lowered since last December and these imply a reduction of between ½ and ¾ of a percentage point in the forecasts made last autumn for Western Europe and North America. However, it is important to stress two points: first, that the Asian crisis is complex in that it is likely to affect a large number of variables not all of which are easy to estimate or included in the standard forecasting models; and, second, that actual developments will also depend on the monetary and fiscal policies adopted in the major market economies.

14. Among the principal factors behind the improvement in the growth performance of the market economies in the last few years have been falling rates of inflation and lower interest rates. These developments are likely to continue: inflation rates and expectations are remarkably low, and the policy commitment to price stability has if anything increased in the run-up to Economic and Monetary Union (EMU); and expectations of further increases in interest rates have weakened since the beginning of the year. If maintained, such developments would help to maintain domestic demand and in Europe they should continue to partly offset the deflationary impact of the fiscal consolidation required by the Maastricht criteria.

15. The current national forecasts point to no change in the average annual rate of GDP growth in Western Europe, that is to say, it is expected to remain at about 2.7 per cent. In the slow-growing countries of the last few years (France, Germany and Italy) GDP should pick up gradually (to some 2.5 to 2.8 per cent) but this will be offset by slower growth in the United Kingdom and in many of the smaller European economies.

16. In the United States, domestic demand is still likely to remain quite strong in 1998, but the effective exchange-rate appreciation of the dollar and the spillover effects from Asia are likely to produce a significant fall in net exports. (It is this latter deterioration that is seen by the United States monetary authorities as an alternative to the rise in interest rates which would otherwise have been considered appropriate.) In short, GDP growth is expected to slow to about 2.5 per cent, from 3.8 per cent in 1997; this would imply an average growth rate of just over 2.5 per cent for the ECE market economies as a whole.

17. The direct effects of the Asian crisis on the transition economies are likely to be small. The East Asian markets take only about 2 per cent of the total exports of Eastern Europe and the proportion is even less for the Baltic States. The Russian Federation has important links with China, but not with the other Asian economies. The transition economies could face greater competition from Asian exporters in their principal markets; however, although this possibility cannot be dismissed, Asian exports do not appear in general to be close substitutes for those from Eastern Europe and the Baltic States. The main effect of any global shocks on Eastern Europe will thus be felt through their impact on Western European import demand. There could also be important effects on the supply of net capital inflows and the cost of finance; these are difficult to anticipate, although, to date, there does not appear to have been any serious impact. However, a number of loan and bond issues by entities in the transition economies have in fact been postponed, and the spreads or risk premiums demanded by foreign investors are still higher than they were before October 1997.[8] Domestic interest rates are also higher in most countries and in the Russian Federation and Ukraine, at least, this is almost entirely due to the effects of the Asian crisis.

18. In aggregate, Eastern European GDP is expected to grow by about 4 ½ per cent in 1998. This improvement on the 1997 performance would largely be due to a return to growth in Albania and Bulgaria and an end to decline in Romania. In the faster-growing economies of 1997 (Croatia, Poland and Slovakia), there will be some deceleration as policies are tightened to check the growth of current account deficits. Even so, these three economies are still expected to grow by 5 per cent or more. High rates of growth (5 to 7 per cent) are also expected in the Baltic States, despite some slowing down in Estonia to avoid overheating. An important problem facing many Eastern European economies in 1998

is how to handle their large current account deficits (many of these are 6 per cent or more of GDP and the figures are even higher in the Baltic States) (see table 4), especially in the more uncertain climate prevailing after the Asian crisis and, more generally, in the light of the difficulties created by the volatility of international capital flows (see below).

19. The Russian economy is also vulnerable to fluctuations on international capital markets and to the behaviour of foreign investors, since a large share of the Government's budget deficit is currently financed by foreign portfolio funds. Within Russian official circles, there is at present a wide range of forecasts for the current year but these are often little more than working assumptions or guesstimates. It is difficult to see a significant strengthening of the recovery in the Russian Federation if monetary policy remains as tight as it is at present for any length of time. Moreover an important constraint on medium-term growth in the Russian Federation is the effect of a large 10-year decline in fixed investment on productive capacities. There was in fact a first, small increase of investment in the last quarter of 1997, but whether this fragile beginning will lead to a sustained recovery remains to be seen.

C. Uncertainties

20. One of the major uncertainties facing the world and ECE economies in 1998 is whether the Asian crisis will have much larger negative effects on real activity than are currently allowed for.[9]

21. The generally optimistic view, as outlined above, tends to emphasize the relatively low trade dependence on South-East Asia of most of the Western market economies. This view ignores, however, a number of other issues. The first concerns the fact that there are many items in the external accounts other than merchandise trade that will be affected by the crisis. Many Western companies derive large profits from Asia without exporting there, as do many banks from their investments in the area, many of which are now at risk. In addition there are a large number of services that will be affected. The net impact on all these flows of income and capital is uncertain, partly because the relevant data are not readily available and partly because many of them are not articulated in the standard forecasting models used to assess such shocks.

22. The second issue concerns the ways in which the Asian economies will attempt to address their problems. Their basic problem is to be able to service and repay their foreign debts. They could obtain the necessary funds by borrowing more money, but this does not appear feasible at the present time; so they will have to boost exports and/or cut imports in order to generate the necessary foreign exchange. Since there are likely to be social constraints on the extent to which imports can be cut, most of the adjustment is therefore likely to come from increased exports; but that increase in exports must find a higher level of demand elsewhere in the global economy. However, it is not clear where such a demand will come from. As noted above, the United States economy is expected to slow down this year and in Western Europe, where macroeconomic policies are focused on meeting the requirements for EMU membership and are unlikely to be relaxed, growth is set to remain more or less unchanged from last year. In this situation, the greatly increased competitiveness of Asian exporters may lead to a much sharper fall in the trade balances of the developed market economies than is currently expected. For Western Europe and Japan, this would imply a reduction in their trade surpluses and for the United States a larger trade deficit – although for Japan the opposite appears to be happening. Since the trade links of Asia are much stronger with the United States than with Western Europe, and given that the Japanese economy, a major outlet for Asian exports, may hardly grow at all in 1998, most of the increase in Asian exports is likely to go to the United States. This might not seem to present a major problem given the current strength of the United States economy – but the current strength may be deceptive.

23. One of the principal driving forces of growth in the United States over the last few years has been consumer spending; and this in turn has been supported by rising employment, increased real incomes, and the wealth and income effects of a booming stock market. However, expenditure of households has persistently been running ahead of their disposable income since 1994 and they have achieved this by reducing the figure expressing their savings as a proportion of income to its lowest level (3.8 per cent) since the Second World War and by heavy borrowing. At the end of 1997, household debt was equivalent to about 85 per cent of personal disposable income, a level which involves a heavy burden of debt servicing. This entails a situation where even small reductions in income or in lending by the banks and other financial institutions can lead to sudden cuts in consumer spending as borrowers anticipate that they may not be able to finance their debts. The reduction in incomes could arise from the larger-than-expected subtraction of net imports from domestic output or from a reduction in lending by institutions that might be anticipating the slowdown in income growth or adjusting their portfolios for possible losses in connection with their previous lending to the Asian economies. The net result – unless offset by increased

Table 4

International trade and external balances of the ECE transition economies, 1995-1997

(Rates of change and shares: percentage)

	Merchandise exports in dollars (growth rate)			*Merchandise imports in dollars (growth rate)*			*Trade balance (percentage of GDP)*			*Current account (percentage of GDP)*		
	1995	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	27 7	2 3	5 8	32 3	13 8	5 0	-6 3	-9 5	-9 8	-0 3	-3 8	-3 9
Albania	45 5	4 4	-38 4	18 4	40 0	-47 5						
Bosnia and Herzegovina	..	144 7	32 8		129 9	-1 2						
Bulgaria	34 3	-8 8	-1 9	35 1	-10 4	-13 6	-2 3	-1 9	4 0	-0 2	0 2	4 3
Croatia	8 7	-2 6	-3 8	43 6	3 7	17 1	-15 3	-16 6	-25 7	-6 8	-4 5	-7 0
Czech Republic	33 6	1 2	2 8	45 0	9 7	-2 7	-7 2	-10 3	-8 4	-2 7	-7 6	-6 0
Hungary	20 2	2 2	21 4	6 3	4 8	16 3	-5 8	-5 4	-4 5	-5 6	-3 7	-2 2
Poland	32 8	6 8	6 4	34 7	27 9	13 2	-5 2	-9 4	-11 8	4 6	-1 0	-3 2
Romania	28 6	2 2	5 6	44 6	11 3	-2 0	-6 6	-9 4	-7 7	-5 0	-7 2	-6 1
Slovakia	27 9	3 0	-0 5	32 3	26 9	-7 8	-1 1	-12 1	-7 6	3 7	-11 1	-7 7
Slovenia	21 8	-0 1	0 8	30 0	-0 7	-0 7	-6 3	-5 9	-5 5	-0 1	0 2	0 6
The former Yugoslav Republic of Macedonia	10 8	-4 7	3 0	15 8	-5 4	8 0	-12 8	-12 2	-17 8	-5 5	-7 3	-6 3
Yugoslavia		20 3	28 6		53 9	17 0	-12 2	-14 1	-13 4			
Baltic States	35 2	17 6	22 2	41 7	26 0	26 1	-15 4	-18 6	-22 5	-5 8	-8 3	-8 5
Estonia	40 6	13 1	39 5	53 0	26 2	37 3	-19 5	-25 9	-32 8	-5 1	-9 7	-9 2
Latvia	31 9	10 7	15 8	46 6	27 6	17 3	-11 5	-17 4	-19 1	-0 4	-5 6	-7 9
Lithuania	33 3	24 0	14 3	31 0	24 9	22 7	-15 8	-15 3	-19 4	-10 3	-9 2	-8 7
CIS	27 7	10 3	1 4	24 4	6 0	17 9	7 7	7 3	5 3	2 2	2 5	0 5
Armenia	74 1	60 6	-15 0	80 9	70 0	2 6	-18 6	-26 1	-29 0			
Azerbaijan	-7 0	-3 1	20 2	50 7	41 1	-29 1	-3 6	-8 8	-0 8			
Belarus	72 2	6 3	1 4	93 5	25 6	17 1	-1 1	-3 5	-6 5	-5 5	-3 7	-6 4
Georgia	48 7	21 2	60 7	253 2	80 3	42 2	-5 2	-8 2	-9 7			
Kazakhstan	72 7	17 7	27 5	-15 3	10 5	51 9	7 0	7 0	6 9			
Kyrgyzstan	19 7	-20 0	141 1	56 5	107 6	-25 9	-1 9	-13 4	0 6			
Republic of Moldova	74 4	-8 4	-17 8	48 5	52 7	31 3	0 5	-9 6	-17 9	-8 1	-12 9	-18 0
Russian Federation	23 9	8 7	-1 6	17 0	-4 9	22 3	9 1	9 0	6 4	3 0	3 3	1 4
Tajikistan	24 4	-11 6	7 0	5 7	-13 9	5 0	35 3	14 6	18 4			
Turkmenistan	92 5	-42 1	-51 0	-20 8	49 3	-43 7	9 0	-20 3	-17 0			
Ukraine	32 6	13 0	22 1	88 7	18 8	4 7	1 8	1 0	3 4	-3 1	-2 7	-2 3
Uzbekistan	77 2	94 0		35 6	96 0		0 8	0 9				
Total	**27.9**	**6.2**	**4.5**	**30.4**	**12.0**	**9.2**	**1.4**	**0.3**	**-0.9**	**0.9**	**-0.2**	**-1.4**
Memorandum items												
CETE-5	28 8	3 1	6 5	30 5	15 4	5 8	-5 5	-8 9	-9 2	0 9	-3 4	-3 7
SETE-7	23 5	-0 7	3 2	39 1	9 6	2 6	-8 9	-11 2	-11 8	-4 6	-5 4	-4 4

Sources: National statistics, Commonwealth of Independent States (CIS) Statistical Committee and direct communications from national statistical offices to the Economic Commission for Europe (ECE) secretariat computations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the "new trade" among the successor States of the former Czechoslovakia and the former Socialist Federal Republic of Yugoslavia, but not intra-CIS trade. Current account data for 1997 are a combination of full year results, estimates or official forecasts in the case of the Eastern European countries, and January-September 1997 values for the Baltic and CIS States. Current account data for the Russian Federation for 1997 refer to relations with the "far abroad" (non-CIS countries) only, whereas those for other CIS countries cover all external relations (non-CIS and CIS). Current-price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 3.

Two dots (..) indicate data not available.

demand from the government sector or from abroad – would be a scramble to reduce household indebtedness and a sharp deceleration in the growth of GDP. If neither of these possibilities were to materialize, there would presumably be increased pressures for protection against higher levels of imports.

24. At present, the outlook for the Western European economies encompasses only a modest improvement in the average rate of growth in 1998, an improvement that assumes that the growth in domestic demand will offset a weaker contribution to growth from net exports. However, the recovery of domestic demand is still somewhat hesitant, especially in Germany, and a more rapid deceleration in export growth than is currently forecast might therefore have a more serious effect on expectations than in circumstances where growth was already well established at a higher rate than at present. A weaker performance in Western Europe would then have negative consequences for the transition economies.

25. The probability of such a scenario's becoming actual is obviously difficult to determine but it is certainly not zero and it is at least sufficiently high to concern the Chairman of the United States Federal Reserve.[10] Nevertheless, the likelihood will be reduced if policy makers are at least prepared to implement appropriate measures to accommodate the increase in Asian exports. It might also be prudent to ensure that the International Monetary Fund (IMF) is provided with the funds it has requested to deal with the possible consequences should global demand not be sustained.

26. In Western Europe, however, the preparations for the introduction of a common currency on 1 January 1999, like any major institutional change, are bound to inject a large measure of uncertainly into the economic outlook in the next year or so. Although a strengthening in the growth rate of the European economy is an important requirement for increasing popular support and acceptance of the new monetary regime, it is by no means clear that policy initiatives would be forthcoming to offset any faltering in the recovery of domestic demand.

D. The Euro *ante portas*

27. On 2 May 1998, the European Council will decide[11] which member countries of the European Union (EU) will adopt a common currency – the Eurodollar (Euro) – as from 1 January 1999. On the same day, the bilateral conversion rates of the national currencies of participating countries will be fixed, a move that is designed to discourage speculative attacks in the interim. The rates of conversion[12] of national currencies to the Euro will be irrevocably fixed on 1 January 1999 and from that day on EMU will become operational. The single monetary policy of EMU will be conducted by the European Central Bank (ECB). National currencies will become subunits of the Euro. Circulation of Euro banknotes and coins will start, at the latest, at the beginning of the year 2002, and by 1 July 2002 national banknotes and coins will cease to be legal tender.

28. At this time, the time of the writing of the *Economic Survey of Europe, 1998*, it is virtually certain that the third stage of EMU will start with 11 countries, namely, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. According to the European Commission, these countries have achieved the necessary degree of convergence in terms of inflation, long-term interest rates, government budget deficits and government debt. In addition, they have met the exchange-rate requirement, that is to say, their exchange rates have remained stable within the normal fluctuation margins of the exchange-rate mechanism (ERM) of the European Monetary System (EMS) for the last two years.[13] Among the remaining four EU countries, Denmark, Sweden and the United Kingdom have announced their intention not to participate in the third stage of EMU from its inception, but they have not excluded the possibility of membership at a later date. Greece is judged to be not yet in compliance with the convergence criteria.

29. The current EMS, which will cease to exist at the end of 1998, has been described as the "most significant and effective international exchange rate arrangement operating since the breakdown of the Bretton Woods".[14] Its phasing out and the beginning of EMU in 1999 constitute a watershed in post-war European history.[15] EMU is a project driven essentially by political and historical considerations, and the primacy of politics is repeatedly stressed by the leaders of the member countries of EU. Nevertheless, the implications and consequences for European economies and for economic policies are obviously considerable, and it is with some of these that the following paragraphs are concerned.

30. The adoption of a single currency can be seen as a complement to the single market, and it is intended to further deepen the economic and financial integration of the European countries. Whether the Euro will also be a vehicle to accelerate the political integration of EU remains to be seen. In any case, the emphasis of the Maastricht Treaty on European Union on nominal economic convergence has led to an asymmetry in the development of the monetary and political integration of EU countries. In fact, a monetary

union without political union is virtually unprecedented for such a large, heterogeneous group of industrialized economies.[16] It is important to note that there are no legal provisions for an orderly exit of a country from EMU.

31. While there will be a single monetary policy in EMU, economic, fiscal and social policy remains largely within the competence of national Governments. The new ECB will be in charge of monetary policy in the Euro-zone from the beginning of 1999. Its primary objective is to maintain price stability. The monetary policy strategy for stage three is still to be decided, with a basic choice to be made between monetary targeting and direct inflation targeting. A major uncertainty surrounds the characteristics of the average monetary policy transmission process in the Euro area,[17] given, *inter alia*, the significant differences in financial structures of the EU countries. Also, a new exchange-rate mechanism (ERM2) will, in principle, link the currencies of the EU countries that are outside the Euro-zone (the so-called pre-ins) to the Euro; but it is not clear whether all four of the countries will actually be prepared to enter this mechanism as from the beginning of 1999.

32. The scope for independent national fiscal policy will in practice be constrained by the provisions of the Stability and Growth Pact, which was concluded at the Amsterdam European Council in June 1997. The Pact clarifies the so-called excessive deficit procedure of the Maastricht Treaty; it defines the adverse economic conditions under which a budget deficit may exceed 3 per cent of GDP; and it provides for the imposition of sanctions or fines if this ceiling is exceeded in "normal" times. The Pact orients fiscal policy towards a balanced budget or a budget surplus in order to provide a sufficient margin for the working of automatic stabilizers in case of an economic downturn. A major rationale of the Pact is to reduce the risk of an adverse policy mix, which could put an excessive burden on monetary policy in regard to offsetting the inflationary pressures associated with "excessive" government spending. It is designed to prevent the accumulation of high levels of government debt and the risk of pressures for inflationary debt bailouts. More generally, the Pact can be regarded as a partial substitute for policy coordination and a common "stability culture".[18]

Costs and benefits

33. The economic costs and benefits of the shift to a single currency are well known from the theory of monetary integration and the theory of optimum currency areas.[19] Benefits arise mainly at the microeconomic level by the elimination of those transaction costs arising from the need to exchange national currencies against those of other countries in the union. A common currency should also reduce the segmentation of markets by increasing price transparency. This should lead to more intensive competition with associated benefits for final consumers of goods and services. A common currency will also eliminate exchange-rate uncertainty within the monetary union and hence remove the costs of foreign exchange hedging. In theory, reduced exchange-rate uncertainty could have a positive effect on output growth, but the empirical link between exchange-rate uncertainty and economic growth has been found to be rather weak.

34. The main cost associated with a monetary union is the loss of control over the domestic money supply and therefore over interest rates as a policy instrument. It also means the loss of exchange-rate flexibility as an adjustment mechanism for dealing with long-lasting asymmetric shocks, to wit, adverse economic events that affect individual countries to different degrees. A single monetary policy also implies a much reduced scope for differences in inflation rates among countries. To the extent that inflation ranks differently among the economic policy objectives of the countries in the Euro-zone, their expected net benefit from a monetary union will vary accordingly.

35. The need for nominal exchange-rate adjustments, to wit, a devaluation, in the event of an adverse economic shock can, however, be offset by flexible labour and product markets. The nominal exchange rate can be seen as an instrument for changing the real exchange rate without adjusting nominal wages. Without this instrument, there must instead be price and quantity adjustments in the product and labour markets of individual countries. This is why European policy makers have been stressing the importance of flexible labour markets and product markets in the monetary union. If prices and wages are not flexible, then the full burden of the adjustment will have to be borne by quantities -- with severe consequences for the labour market. In other words, downward wage flexibility is of vital importance for the success of EMU.[20]

36. Another dimension of flexible labour markets is labour mobility. In contrast to the United States, labour mobility has been traditionally rather limited in Western Europe, both within and between countries, largely for cultural and linguistic reasons. In any case, labour mobility itself is not costless and is also dependent on a flexible market for housing. Labour mobility is unlikely to be able to significantly reduce the need for more wage flexibility and will only be efficient in the case of permanent asymmetric shocks.

37. An alternative adjustment mechanism would be a fiscal redistribution system with counter-cyclical transfers between regions and a central Government. The EU budget, however, is relatively small, corresponding to only some 1.2 per cent of the combined gross national product (GNP) of member countries, and it is unlikely that proposals to enlarge the scale of transfer payments will find the necessary political support. It has also been argued that in view of the redistribution system that already exists within the various countries of EU, the potential to provide additional interregional insurance against asymmetric shocks is relatively modest.[21] In any case, while fiscal transfers might cushion the consequences of an adverse shock, they would not remove the eventual need for an adjustment of relative prices and wages.

38. Apart from fiscal transfers, there is the more general question of the appropriate policy mix. With a centralized monetary policy focusing on price stability, the scope for a flexible use of fiscal policy in the individual countries to offset adverse shocks becomes, in principle, all the greater. This is particularly so in the case of limited downward flexibility in nominal wages; but the Stability and Growth Pact limits the room for manoeuvre of fiscal policy and could even restrain the operation of automatic stabilizers when they are needed.

Impact of the Euro

39. The adoption of a single currency will lead the European economies into uncharted territory, making it virtually impossible to gauge the impact on EMU members and the global economy at large. This amounts to a fundamental change in the international monetary system, with three of the Group of Seven (G-7) countries giving up their national currencies. What role the Euro will play as, for example, an international reserve currency, and how important Euro-denominated financial assets will be in the portfolios of international investors are largely matters of speculation. It also remains to be seen how strong the Euro will be relative to the dollar and the yen and whether the dollar-Euro exchange rate will be more or less volatile than the dollar-deutsche mark rate. Similarly, it is difficult to judge the likely relative stability of the real effective exchange rate of the Euro.

40. Inside the Euro-zone, the focus of cyclical analysis will shift from country-specific developments to the (weighted) averages of economic variables for the member countries. This pertains notably to inflation performance relative to the inflation target of monetary policy. There will be only a single short-term interest rate, which may not always be appropriate for all countries in the event of diverging cyclical developments. Another open issue is the impact of monetary policy on the average change in output and demand in the Euro-zone and the variation in these effects between the individual countries.[22]

41. At present, there is in fact quite a marked degree of cyclical desynchronization among the prospective EMU members (see chap. 2.2 (i) of the *Economic Survey of Europe, 1998*). In countries such as Finland, Ireland and Spain which are more advanced in the business cycle than other countries, especially Austria, Belgium, France, Germany and Italy, inflationary pressures are larger and there might, in principle, be a need for higher interest rates; but higher interest rates would not be appropriate for the latter group, at this stage. Earlier expectations that short-term interest rates would converge somewhere at the mid-point of the range between the low and high interest rate countries appear to have been revised; it is now expected that they will decline to French and German levels. This will provide an additional monetary impulse to economic activity at the "periphery", which will be felt, with a lag, in the course of 1999. If it persists, this cyclical desynchronization will not facilitate the task of ECB. In any case, from the outset ECB will have to convince the financial markets of its credibility in terms of being able to meet its inflation target.

42. Fiscal policy in the Euro-zone will have to remain tight for some time to come. In many countries, either budget deficits are close to 3 per cent or debt levels are significantly above the norm of 60 per cent of GDP in 1997. The structural budget deficit for the EU member States is estimated to have been 2 per cent of GDP in 1997 with no significant reductions projected for 1998 and 1999.[23] Under such circumstances, the fact that the Stability and Growth Pact may become a problem even in the event of only a slight cyclical setback could mean having to test the provisions of the Pact at an early stage and when the new ECB is still being required to establish its credibility.[24] This almost certainly implies continuing fiscal retrenchment in EMU countries to avert the embarrassment of sanctions' or fines' having to be imposed should the provisions of the Stability and Growth Pact be violated. The macroeconomic costs of the Pact will only begin to wane once a comfortable budget surplus has been achieved.[25] The reduction of budget deficits does not, of course, have to rely only on fiscal retrenchment. As illustrated by the experience in the United States, a sustained and strong rate of economic growth is the most conductive environment for budget consolidation; but in Western Europe this also requires a better balance between domestic and external growth forces. To achieve

sustained economic growth, labour-market reforms alone are unlikely to suffice.

43. Unemployment in the future Euro-zone is still very high, and a large part of it is widely regarded as structural although, as suggested earlier, this may well be exaggerated. The Euro will undoubtedly intensify competitive pressures in the labour markets. It is hoped that labour markets will become more flexible, in the sense that nominal wages will not be rigid downwards and that labour mobility will increase; but the European experience over many decades does not encourage optimism in this respect. The adjustment burden that will be put on the labour market could therefore be considerable and could erode popular support for the Euro; it could even be the source of major social and political tensions should the labour-market situation continue to deteriorate. Also, if workers are not mobile and wages are not flexible there will then be increased pressures for interregional transfers, to which several member Governments are at present adamantly opposed.

44. In general, the net economic benefit from a monetary union, other things being equal, will decrease with increasing heterogeneity in the economic structures of member States, and in their monetary policy preferences, and with increased asymmetry in the economic shocks experienced. The less efficient are the adjustment mechanisms in the goods and labour markets and in the fiscal system, the larger will be the potential for tensions and the smaller the net economic gain to be reaped from a single currency.[26] Since EMU clearly will not constitute an optimum currency area, the question is whether all its members will benefit from the union to the extent that they expect and how such benefit might compare with that derived from the existing monetary policy and exchange-rate arrangements.

E. "Catching up" in a global economy: sustaining growth in the transition economies

45. The difficulties experienced recently in certain emerging markets (including some transition economies) have brought to the forefront of public debate some new aspects of the dichotomy between growth and stability, especially during a turbulent process of structural change. Recent developments have pointed to the emergence of several new dimensions of the concept of economic stability in an environment of global financial markets characterized by volatile capital flows.

46. The countries that are undergoing a profound transformation from a planned to a market economy face numerous serious challenges arising from this fundamental change. Since the issues have been the focus of wide public, academic and policy debates in recent years, the following discussion will concentrate only on some of them – those that appear to require a certain degree of reconsideration in the light of recent developments.

47. One of the central issues that underlie, explicitly or implicitly, the very concept of economic transformation is that of catching up with the developed market economies. During their long insulation from world markets, the former centrally planned economies fell steadily behind the levels of development of the Western economies owing to the inefficiencies embodied in their economic system. Their full-fledged reintegration into the world economy requires a catch-up, in the first place, in terms of productivity. The transition economies need to achieve substantial gains in productivity in order to be able to persist in maintaining for some time higher rates of economic growth than those prevailing in the developed market economies. Given the aspiration of a large group of European transition economies to join EU, this can also be regarded as an explicit policy target, since one of the fundamental prerequisites of a successful and smooth accession is a significant narrowing of the existing income gap between the transition economies and the present members of EU.

48. The issue of growth during the transition and of the factors that affect it has also been widely discussed by professional economists and in international bodies.[27] However, most of this discussion has tended to focus on the potential of the transition economies to achieve the required productivity gains and to maintain relatively high rates of economic growth over a long period of time (the prerequisite of a catch-up's occurring in the first place). The issue of sustainability has also been addressed but mostly as regards the underpinning of the supply and demand factors of growth, and not so much from the point of view of maintaining simultaneously high rates of growth and systemic stability in a volatile global environment. The recent financial crises have drawn attention precisely to the latter aspect of the catching-up process.

49. Owing to the generally obsolete, inefficient and insufficient productive capacities in the transition economies and to their generally limited domestic financial resources, they need to raise additional resources from abroad in order to obtain the required productivity gains. Indeed, with the strengthening of economic recovery, there has emerged a systematic lag between the growth of total domestic output and the growth of final domestic demand. The gap has been

covered by foreign capital which has surged into many transition economies. This imbalance – which is common in periods of fast recovery or of catching up – is one of the main reasons for the chronic trade and current account deficits that have emerged in the majority of the transition economies.

50. Current account deficits are not unequivocal threats to growth and stability since they can be sustained for long periods, provided that the country remains a net source of attractive business investment opportunities. In such a case, the country will import capital to close the domestic savings-investment gap (which results in the persistent current account deficit). As long as the main conditions that determine such attractiveness are preserved, the economy may grow and remain stable, despite the persistent disequilibrium between domestic output and domestic absorption. Actually, this is a model of development that has been followed in many fast-growing developing economies, including some of the "tiger" economies in Asia. However, the recent financial crises have raised some new concerns about the systemic stability of such a growth model in an international environment of volatile capital flows.

51. There are a number of stability-related issues stemming from the problems of financing persistent current account deficits.[28] One of the relatively recent developments, which has a direct impact on overall stability, concerns the fact that with the globalization of financial markets the volatility of capital flows has increased substantially. Moreover, the major share of global financial flows are practically beyond the reach of national and international policy-making. It is this considerable volatility of capital flows that may require some reconsideration of the mechanisms for maintaining financial and economic stability, since a high exposure to foreign capital carries an inherent risk of negative shocks to the economy owing to a reversal of the capital inflow, which is possible even when the economic fundamentals are sound and policies are coherent.

52. In addition, there are some other aspects of stability to be considered when growth is predominantly export-led and based on a narrow range of specializations. In such cases, a country may be more susceptible to external demand shocks, and the transition economies appear to be especially vulnerable in this respect. The problem is both developmental and structural in nature. A mismatch between the growth of output and that of domestic demand is not unusual during a process of catching up and very often it has highly specific compositional characteristics. The apparent excessive domestic demand often reflects domestic supply-side constraints, namely, the fact that domestic production is not in a position to meet or respond to the growing demand for certain products (for example, sophisticated technological and other investment equipment, high-quality consumption goods, and so forth). This indicates a significant discrepancy between the composition of domestic output and that of domestic demand as well as between exports and imports. It is this compositional mismatch that makes it difficult – if not impossible – to substitute domestic demand for export demand in the event of a disturbance on foreign markets. In such a situation, a fall in export demand would translate into a full-scale negative demand shock.

53. The exposure to this type of demand shock will be greater if the composition of exports is dominated by products that are subject to cyclical fluctuation (such as basic commodities and raw materials which are often subject to pronounced cyclical variations in both prices and real demand). Thus a catch-up process that includes a general upgrading and diversification of the product and export structure – as well as of export markets – would at the same time reduce the overall degree of vulnerability to external shocks. Recent changes in the composition of trade[29] suggest that the beginnings of such a process may be under way in some of the more advanced transition economies. Conversely, the longer the transition economies depend largely on unprocessed or semi-processed goods for their export earnings (as many of them still do), the longer they will be subject to adverse demand effects on their external markets.

54. Finally, there appear to be some limitations on the set of policy measures available to policy makers in the transition countries in respect of coping with equilibrium issues during the catch-up process. The main problem – which limits the efficiency of supply-side policies in these circumstances – is that, *ex ante*, it is not clear in what direction the final demand components will change in response to changes in output.[30] Basically, this leaves the authorities with the traditional instruments of fiscal and monetary policy for curbing domestic demand and, in fact, these were increasingly employed (especially in 1997) in a number of transition countries.

55. To sum up, the countries in transition are likely to face some new challenges in the process of catching up owing to the increased volatility in global financial markets and to the inherent weaknesses of their economies; at the same time, the policy choices of the authorities of these countries in coping with such challenges may be rather limited. One of the implications is that if the authorities in a fast-growing country with a persistent external imbalance wish to reduce such a risk they may need to deliberately lower the pace of economic growth below its potentially feasible rate. This

deflationary bias may be regarded as the price of stability during a process of fundamental restructuring in a globalized economy. It should be emphasized that the present discussion of stability-related issues should not be regarded as a rejection of the case to be made for high rates of growth during the transition from plan to market. On the contrary, there is no alternative to high growth rates if catching up is to take place. The point is to draw more attention to the existence of the additional risks and problems that are associated with this process in a "global" economy and which policy makers in the transition countries will need to take into account in order to be able to set both feasible and sustainable growth targets.

Notes

[1] The region of the Economic Commission for Europe (ECE) comprises the member countries of ECE namely, the whole of Europe (East and West, and including the Baltic States), the Commonwealth of Independent States (CIS), North America and Israel.

[2] An important and detailed survey of labour-market rigidities in Europe and the United States shows that many of the alleged rigidities in Europe (including employment protection legislation and minimum labour standards) do not appear to have any significant impact on unemployment levels, while many serve a distinctly useful social purpose. Even generous unemployment benefits do not appear to raise unemployment as long as they are limited in duration and accompanied by incentives to improve the ability and willingness of the unemployed to find work. There are certain combinations of arrangements that appear to have a negative effect on employment creation but those tend to be fairly specific and do not justify a blanket condemnation of European labour-market practices as "rigid and inflexible". (See S. Nickell, "Unemployment and labour market rigidities: Europe versus North America", *Journal of Economic Perspectives*, vol. 11, No. 3 (summer 1997).)

[3] Price indices actually pick up relative price changes as well as general (inflationary) increases in prices. The former, which reflect the normal working of the market system, may become relatively more important at very low rates of overall change. Macro-policy reactions to small increases in monthly price indices might therefore frustrate the reallocative role of the price mechanism.

[4] The Czech currency crisis is the subject of a special subsection (chap. 3.2 (v)) in the *Economic Survey of Europe, 1998*, No. 1 (United Nations publication, Sales No. E.98.II.E.1).

[5] Chap. 3.6 (ii) of *Economic Survey of Europe, 1998*, No. 1.

[6] The data on the sectoral distribution of private sector employment are still fragmentary and are not available for 1997. The relative importance of services as a source of new jobs in the Czech case may be a temporary feature reflecting the delays in restructuring enterprises in the industrial sector.

[7] The crisis in Asia and its possible effects on ECE member countries are discussed at length in chap. 2.1 (ii) of the *Economic Survey of Europe, 1998*, No. 1; for the impact of the crisis on flows of foreign direct investment (FDI), see chap. 3.2 (ii).

[8] See chap. 3.2 (ii) and 3.6 (vi) of the *Economic Survey of Europe, 1998*, No. 1.

[9] The global financial markets appear to have decided that the worst is over but, since one lesson of the Asian crisis (and that of Mexico before it) is that many international investors do not look very closely at the fundamentals of the real economies in which they place other people's funds, perhaps such a response should not be relied upon too heavily.

[10] In testimony before the Committee on Banking and Financial Services, United States House of Representatives, 30 January 1998, Chairman Alan Greenspan warned that "the upset in East Asia could have unexpectedly negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States. ... while the probability of such an outcome may be small, its consequences, in my judgement, should not be left solely to chance. We have observed that global financial markets, as currently organized, do not always achieve an appropriate equilibrium, or at least require time to stabilize" (Federal Reserve Board, Internet Web site).

[11] The decision of the European Council (consisting of the heads of State or Government) will be based on a recommendation from the Council of Finance Ministers of EU (Ecofin), which will have at its disposal separate reports prepared by the European Commission and the European Monetary Institute as to how EU member countries have complied with the convergence criteria established in the Maastricht Treaty.

[12] This will depend on the exchange rates of the national currencies against the market value of private European Currency Units (ECUs) on 31 December 1998. The European Council agreed in June 1997 that references to the ECU in legal instruments will be replaced by references to the Euro at 1:1 parity; but the ECU is a basket of currencies of 12 out of 15 member States of EU and not all of those 12 will adopt the single currency at the beginning of 1999.

[13] Finland joined the exchange rate mechanism (ERM) only in October 1996. Italy, which had suspended membership in autumn 1992, re-entered in November 1996. Among the remaining EU member States, Sweden and the United Kingdom are not participating in ERM, and Greece joined only in March 1998.

[14] W. M. Corden, *Economic Policy, Exchange Rates and the International System* (Oxford, United Kingdom, Oxford University Press, 1994), p. 105.

[15] Economic and monetary union was proposed for the first time in the Werner report in 1970 for the then members of the European Community. The basic vehicle for this was the narrowing of exchange-rate fluctuations, which led to the "snake" in April 1972; but the fact that France, Italy and the United Kingdom had left the snake by 1974 basically marked the end of the Werner process. The current European Monetary System (EMS) was created in 1979. Plans for a

monetary union re-emerged in 1988. In 1989, the Delors report proposed to move to monetary union in three stages; the Maastricht Treaty of 1991 then provided the legal framework for moving towards a common currency. For an overview, see D. Gros and N. Thygesen, *European Monetary Integration* (London, Longman, 1995); and W. M. Corden, op. cit., pp. 150-152.

[16] The main precedents are the Latin currency union and the Scandinavian monetary union. The first was founded in December 1865 by France, Belgium, Italy and Switzerland. Greece joined in 1868. This union fell apart de facto during the First World War, but it was dissolved formally after Belgium left the union at the beginning of 1927. The Scandinavian monetary union had Denmark, Norway and Sweden as members. It was created in December 1872 and ended in 1924. See T. Theurl, "Währungsunionen ohne politische Integration: die Lateinische und die Skandinavische Münzunion", *Deutsche Bundesbank, Auszüge aus Presseartikeln*, No. 76 (10 November 1995), pp. 4-12.

[17] European Monetary Institute, *The Single Monetary Policy in Stage Three* (Frankfurt am Main, January 1997).

[18] M. Artis and B. Winkler, "The Stability Pact: safeguarding the credibility of the European Central Bank", *National Institute Economic Review*, No. 163 (January 1998), pp. 87-98. In December 1997, the EU member States agreed to set up a body – known as Euro-X-Council – where ministers of countries in the Euro-zone would discuss matters of common interest. It remains to be seen to what extent this body will become an effective mechanism for informal policy coordination. In any case, Ecofin will remain the only decision-making body for European economic issues.

[19] See, for example, P. De Grauwe, *The Economics of Monetary Union*, 2nd rev. ed. (Oxford, United Kingdom, Oxford University press, 1994); and W. M. Corden, op. cit. There is no single set of criteria that would determine the optimal size of a currency union but there is general agreement that it must involve a degree of factor mobility sufficient to avoid the need for exchange-rate adjustments, that is to say, high capital mobility would enable current account deficits to be financed without the need for depreciation of the exchange rate and high labour mobility would enable a country in deficit to deflate its economy without creating large-scale unemployment. A high degree of financial integration is a corollary of the capital mobility requirement. Other factors that have been singled out in the large literature on this subject as influencing the optimal size of a currency union include the degree of openness of national economies (the ratio of tradable to non-tradable goods and services) and the degree of product diversification of exports and imports.

[20] W. M. Corden, op. cit., p. 130.

[21] Antonio Fatás, "Does EMU need a fiscal federation?", *Economic Policy* (Oxford, United Kingdom), No. 26 (April 1998), pp. 165-203.

[22] There have been marked differences in the real effects of monetary policy among the EU countries in the past, but the differences in the transmission of monetary policy can be expected to narrow in the Euro-zone. See R. Ramaswamy and T. Sloek, "The real effects of monetary policy in the European Union: what are the differences?", *IMF Working Paper* (Washington, D. C., December 1997).

[23] *OECD Economic Outlook* (Paris, December 1997), annex table 31.

[24] M. Artis and B. Winkler, loc. cit.

[25] Barry Eichengreen and Charles Wyplosz, "The Stability Pact: more than a minor nuisance?", *Economic Policy* (Oxford, United Kingdom), No. 26 (April 1998), pp. 67-113.

[26] J. von Hagen, "Monetare, fiskalische und politische Integration: Das Beispiel der USA", *Deutsche Bundesbank, Auszüge aus presseartikeln*, No. 76 (10 November 1995), pp. 13-21.

[27] Previous issues of the *Survey* have discussed in detail the factors of growth during the transition both from the supply and from the demand side. See *Economic Survey of Europe in 1996-1997* (United Nations publication, Sales No. E.97.II.E.1), chap. 3.2 (ii) (b), entitled "Demand-side factors of growth in the transition", and *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1), chap. 3.2 (i) (b) entitled "The supply-side determinants of growth in the transition".

[28] Some of these problems are analysed in more detail in chap. 3.2 (iii) of *Economic Survey of Europe, 1998*, No. 1. See also *Economic Bulletin for Europe*, vol. 49 (1997) (United Nations publication, Sales No. E.97.II.E.23), chap. I.3 (v) entitled "External imbalances and financial vulnerability".

[29] See chap. 3.6 (ii) of *Economic Survey of Europe, 1998*, No. 1.

[30] As regards the transition economies, these limitations partly arise because of the instability and heterogeneity of the elasticities of the components of final domestic demand with respect to changes in output (see chap. 3.3 (ii) of *Economic Survey of Europe, 1998*, No. 1). Consequently, a corrective policy that directly targets supply ("supply-side policy") may not necessarily bring about the required macroeconomic correction (the closing or narrowing of the gap between the growth in output and the growth in demand).